REV-11 REPEAL PERCENTAGE DEPLETION ALLOWANCE AND EXPENSING OF INTANGIBLE DRILLING, EXPLORATION, AND DEVELOPMENT COSTS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Repeal Percentage Depletion	0.9	1.4	1.4	1.5	1.5	6.7
Repeal Expensing of Intangible Drilling, Development, and Exploration Costs	2.0	3.1	2.7	2.4	2.0	12.1
Total	3.9	6.3	5.7	5.2	4.7	25.9

NOTE: These estimates are based on CBO's baseline oil price forecast of $23.60 per barrel in 1987, rising to $27.50 per barrel by 1991. To the extent that actual prices differ from this forecast, revenues may be significantly affected.

Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral properties come in three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or mine excavation; and costs for capital equipment, such as pumps or construction machinery.

In general, mineral acquisition and exploration costs may not be immediately deducted (that is, may not be expensed), but must be "capitalized" and deducted in future years. An exception to this rule allows exploration costs for hard mineral industries (such as coal or iron ore) to be deducted immediately, but recaptures them once a mine is brought into production. (Recapture involves including exploration costs as income in the year the mine begins production.) In general, these capitalized costs are deducted over time through either cost or percentage depletion. Cost depletion allows firms to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves are produced in a given year, 5 percent of the well's unrecovered depletable costs are written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs.

Many taxpayers are allowed the alternative of percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from a property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of their gross revenue from their first 1,000 barrels per day of oil and gas production each year, regardless of their capitalized costs. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include coal (10 percent), uranium (22 percent), oil shale (15 percent), gold (15 percent), and iron ore (14 percent). Percentage depletion is generally considered more generous than cost depletion. Both the President's tax reform proposal and H.R. 3838 would repeal percentage depletion, except for low-producing oil and gas wells.

Mine development costs and oil and gas drilling costs are also immediately deductible, except in the case of integrated producers. Under the Deficit Reduction Act of 1984, the Congress limited expensing of producing wells for integrated oil and gas producers to 80 percent of intangible drilling costs, with the remaining 20 percent deducted over a 36-month period. The President's proposal would retain these provisions; H.R. 3838 would allow continued expensing of some drilling costs, but would require other costs to be amortized over 26 months.

The current tax treatment of mineral properties has been criticized because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that gradually decline in value as oil reserves are depleted. The tax code, however, allows firms to deduct most of these costs in the year incurred. Moreover, percentage depletion often allows firms deductions in excess of their original investment. In some cases, percentage depletion (in present-value terms) is even more generous than immediate expensing of all depletable costs.

The result of these provisions is that mineral producers face effective tax rates that are lower than statutory tax rates and, for many producers, lower than effective tax rates on other industries. This tax advantage could be mostly eliminated by replacing the current set of provisions for mineral capital costs with a new system of cost recovery that required all expenditures on mineral rights, exploration, development, and drilling to be capitalized. Under this proposal, all producers would be allowed the option of recovering these costs through the current provisions for cost depletion or amortizing them over 10 years (using the 250 percent declining balance method, switching to straight-line depreciation after six years). Expenditures on dry holes, unproductive mines, or worthless mineral rights would, however, still be expensed. This proposal would raise about $4 billion in 1987 and $26 billion over the 1987-1991 period.

Opponents of expensing and percentage depletion argue that the inherent subsidy they provide is not needed, especially in the oil and gas industry where prices have risen sharply over the last 12 years. As a result of these subsidies, too much capital is allocated to extractive industries as opposed to other more productive uses. Opponents also argue that this is tantamount to a policy of "draining America first" and will result in greater energy vulnerability in the future. Finally, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. Furthermore, proponents argue that because the oil and gas industry is highly risky, especially for small firms, favorable tax treatment is required so that firms can raise sufficient capital. Advocates also argue that many other forms of equipment and machinery now receive tax treatment that is at least as favorable as mineral capital investment, because of the substantial liberalization of depreciation allowances and investment tax credits. When compared with five-year ACRS property, expensing of development costs or percentage depletion may no longer provide any preferential tax advantage. Also, if account is taken of the windfall profit tax on oil, some investments in the oil industry may even be relatively disadvantaged compared with other industries.

REV-12 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Mortgage Revenue Bonds						
Multiple dwellings	0.1	0.2	0.3	0.4	0.6	1.6
Single-family homes	0.3	0.6	0.7	0.7	0.7	3.0
Industrial Development Bonds						
Small issues	0.1	0.2	0.2	0.3	0.3	1.1
Pollution control	0.1	0.1	0.2	0.4	0.5	1.3
Other	0.1	0.3	0.6	0.9	1.3	3.2
Student Loan Bonds	a/	a/	0.1	0.1	0.1	0.3
Hospital Bonds	0.2	0.5	1.0	1.6	2.2	5.5
Total	0.8	1.9	3.2	4.4	5.7	16.0

a. Less than $50 million.

State and local governments have for many years issued bonds to finance public investments such as schools, highways, and water and sewer systems. In the past 20 years, however, these governments have issued a rapidly increasing volume of bonds to finance private-sector projects, such as shopping centers, industrial plants, and pollution control facilities. Because interest on many of these "private-purpose" bonds, like those on public-purpose bonds, is exempt from federal taxation, rates are lower. These below-market low interest rates constitute a federal subsidy of the borrowing costs of private taxpaying entities. If current law remains in effect, revenue losses from all private-purpose bonds will amount to $15.5 billion in fiscal year 1987, rising to $21.1 billion in 1991. These bonds include mortgage revenue bonds for single-family homes and multiple dwellings; industrial development bonds (IDBs), which lower the borrowing costs of private firms for a wide variety of purposes; private hospital revenue bonds; and student loan bonds.

Tax-exempt bonds are used to subsidize activities that the federal government might want to encourage, such as low-income multifamily housing. They may also, however, subsidize facilities where the arguments for additional federal assistance are weaker or nonexistent, such as private industrial plants. In addition, in many cases, tax-exempt financing merely lowers borrowing costs for investments that would have been undertaken anyway, permitting users to earn arbitrage--that is, to profit from the spread between taxable and tax-exempt rates. Even where a subsidy is warranted and effective in increasing investment in a desired activity, tax-exempt bonds are a much less efficient form of subsidy than direct subsidies because the benefits are shared between the borrower of funds and the investor in tax-exempt bonds. Supporters of tax-exempt financing argue, however, that concerns about inefficiency should not weigh heavily in situations where the Congress is unlikely to enact direct subsidy programs; while direct subsidies may be more efficient, they would prefer inefficient subsidies if the alternative is to be none at all.

Recent tax legislation has included provisions to control the growing use of tax-exempt financing for private purposes. For example, the Deficit Reduction Act of 1984 placed a state-by-state cap on the dollar volume of student loan and industrial development bonds. At the same time, however, it extended for four years the use of mortgage revenue bonds for single-family homes, which had been scheduled to expire at the end of 1983, and it extended the sunset date on small-issue IDBs used for manufacturing to December 31, 1988. Tax exemption of new small-issue IDBs used for any other purpose will expire on December 31, 1986.

Tax reform proposals further limit the use of tax-exempt financing. The President's tax reform proposal would eliminate all tax-exempt financing for private purposes. H.R. 3838, on the other hand, would retain some private-purpose tax-exempt financing, but would limit its growth by extending the state-by-state cap on dollar volume to bonds used for housing, educational facilities, and nonprofit hospitals. At present, the cap applies only to IDBs and student loan bonds. The bill would also repeal the scheduled sunset for small-issue IDBs and eliminate tax exemption for IDBs used to finance pollution control facilities, sports stadiums, and trade show and convention centers.

Mortgage Revenue Bonds. Mortgage revenue bonds provide below-market-interest financing for rental housing and single-family homes for low- and middle-income households. Each state has a limit on the amount of mortgage bonds that it can issue, which is equal to 9 percent of its average annual mortgage originations over three years, or $200 million, whichever is greater. Under current law, states and localities can substitute mortgage credit certificates for single-family mortgage revenue bonds. This program permits the states to authorize federal tax credits to home buyers for mortgages up to an amount equal to the subsidy resulting from tax exemption. If tax exemption of mortgage bonds for multiple dwellings issued after October 1, 1986, was eliminated, it would raise $1.6 billion over the 1987-1991 period. Under current law, the revenue losses from single-family mortgage bonds and mortgage credit certificates will amount to $3.7 billion in fiscal year 1987, rising to $4.0 billion in 1991. If mortgage credit certificates and tax exemption for mortgage revenue bonds were eliminated, the savings would amount to $3.0 billion over five years.

Industrial Development Bonds. IDBs include bonds for a variety of special purposes such as pollution control; airport and port facilities; industrial parks; and trade show and convention centers. They also include so-called "small issues," which may be used for a wide variety of purposes from manufacturing to farming, but cannot exceed $10 million. In 1985, small-issue sales amounted to an estimated $18.6 billion; the volume of pollution control bonds amounted to $7.0 billion; all other bonds equaled $13.1 billion.

The use of all of these industrial development bonds has been controversial. The advocates of eliminating the bonds maintain that the large business tax cuts in the Economic Recovery Tax Act of 1981 reduced the need for additional investment subsidies in general. In fact, the combination of tax-exempt financing, the investment tax credit, and accelerated depreciation results in deductions that exceed expensing for several classes of equipment, thus resulting in negative effective tax rates on some new investment. Supporters of the bonds argue that they promote economic development. Since industrial development bonds can be offered by all jurisdictions, not just economically depressed areas, however, their advantage to poorer communities in competing for new investment is largely canceled out, with the result that the bonds represent a federal subsidy to business with no clear gains for any locality. If use of the bonds was limited to economically depressed areas, $4.4 billion would be raised over the 1987-1991 period. Eliminating IDBs issued for any purpose after October 1, 1986, would raise $5.5 billion over the 1987-1991 period. Eliminating the tax exemption for small-issue IDBs only would raise $1.1 billion.

Student Loan Bonds. State agencies float student loan bonds to increase the amount of funds available for guaranteed student loans. The bonds are an attractive investment because they are among the few securities that are both exempt from taxation and federally guaranteed. In addition, the Department of Education subsidizes the interest costs of student loans directly, although the subsidy rate is reduced in half for those student loans that are financed with the proceeds of tax-exempt bonds. The volume of student loan bonds rose from $0.1 billion in 1977 to $1.4 billion in 1984, and was $1.6 billion in 1985. The federal revenue loss from these bonds is estimated at $2.0 billion between 1987 and 1991; eliminating tax exemption for bonds issued after October 1, 1986, would raise $0.3 billion over the same period. The total budgetary cost of the bonds, and the gain from eliminating them, would be less than the revenue effect because of the lower direct interest subsidy associated with their use.

One can argue that tax-exempt student loan bonds are unnecessary because private banks and the Student Loan Marketing Association (Sallie Mae) provide similar support at the same cost to students without tax-exempt financing. In this view, student loan bonds merely provide arbitrage profits for state authorities. States argue, however, that private market financing has been inadequate and that the additional federal subsidy conveyed by tax-exempt student loan bonds widens accessibility to higher education.

Hospital Bonds. Tax-exempt bonds issued by nonprofit hospitals will account for a revenue loss of $2.8 billion in 1987, rising to $5.0 billion in 1991. Advocates of the bonds maintain that they lead to lower hospital costs; those who support eliminating the bonds question the need for any subsidy when the supply of hospital beds seems to be adequate. Eliminating the subsidy for bonds issued after October 1, 1986, would raise $5.5 billion over the 1987-1991 period.

REV-13 ELIMINATE SPECIAL CAPITAL GAINS TREATMENT FOR TIMBER, AND FOR COAL AND IRON ORE ROYALTIES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1990	1989	1991	
Timber Income	0.3	0.7	0.7	0.8	0.8	3.3
Coal and Iron Ore Royalties	0.1	0.1	0.1	0.1	0.2	0.7

The present tax code does not generally allow capital gains treatment for income from the sale or exchange of business inventories or the normal output of a business. In an exception to the standard treatment, some of the income associated with the production of timber, coal, and domestic iron ore, which would otherwise be taxed as ordinary income, is subject to special provisions that allow it favorable capital gains treatment.

Opponents of this special treatment argue that it reduces economic efficiency by causing more timber to be cut than if production were market-determined, and by distorting choices about the ownership of natural resources. They point out that timber grown for the purpose of producing lumber or paper is no more a capital asset than wine and whiskey, which must be aged to achieve their full market value but are not treated as capital assets under current law.

Proponents of the special capital gains treatment of timber argue that timber producers should be given the same treatment available to farmers or suburban homeowners whose fields or homes bring higher prices because of their windbreaks or shade trees. (The value of a farm or house is increased by its trees, and the seller can claim capital gains treatment for the entire increase in value.) If capital gains treatment was ended for timber, but retained for land, new rules would be necessary to determine when the gain from selling land with trees on it should be taxed as capital gains and when it should be taxed as ordinary income because the seller is in the business of timber production. While these rules would make the tax law more complex, there would also be some offsetting reduction in complexity because no need would exist for rules to distinguish between income from timber growing (which is currently treated as capital gains) and ordinary income from logging and manufacturing.

Proponents of special incentives for timber argue, furthermore, that market forces alone will not spur sufficient timber growing, because the unusually long production process makes it more risky than other investments. They also hold that special treatment of timber income is needed to promote development and conservation of domestic timber resources. The goals of conservation and an assured supply of timber, however, might be achieved more efficiently with direct incentives for planting and conservation of timberlands. Finally, one difficulty in eliminating the present tax-favored status is that owners of timberland would suffer large losses, since the present tax benefits have been capitalized into land values.

The provisions allowing capital gains treatment for royalties from coal and domestic iron ore production are exceptions to the general rule that royalties are ordinary income taxable at regular rates. Without special treatment, owners of coal and iron ore properties might sell their land to get capital gains rates. Repeal of these provisions would end special subsidies available for these two minerals and would equalize treatment between owners who develop their own properties and those who sell the rights.

The President's tax reform proposal would repeal the capital gains treatment of royalties from timber, coal, and domestic iron ore, and would phase out the special capital gains treatment of timber over five years. H.R. 3838 would allow capital gains treatment for timber production and cutting by individual taxpayers, but not by corporations. The capital gains treatment of royalties from timber, coal, and domestic iron and steel would be gradually phased out. The estimates shown above are for complete repeal for both individuals and corporations effective January 1, 1987.

REV-14 ELIMINATE PREFERENCES FOR FINANCIAL INSTITUTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities	0.1	0.3	0.3	0.3	0.3	1.3
Repeal the Deduction for Excess Bad-Debt Reserves	0.5	0.6	0.4	0.6	0.7	2.8
Treat Credit Unions Like Other Thrift Institutions	0.1	0.2	0.2	0.2	0.3	1.1
Repeal the 20 Percent Deduction for Taxable Income from Life Insurance Activities and the Small Life Insurance Company Deduction	1.0	1.7	1.9	2.1	2.2	8.9
Repeal Preferences for Property and Casualty Insurance Companies	0.3	0.6	1.5	2.1	2.5	7.0

Banks, thrift institutions, and life insurance companies receive certain tax preferences that are not allowed other businesses. Additional revenues could be raised by eliminating or reducing such preferences. All of these possible changes would tend to place different financial institutions on a more equal footing, and to result in tax treatment more closely resembling that of other businesses. They might also have negative effects, since each special provision was originally enacted to encourage a particular activity that might be discouraged by repeal.

Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities. Individuals and businesses are generally allowed to deduct from their taxable income interest charges paid on debt incurred in producing taxable, but not tax-exempt, business income. In an exception to this general treatment, banks are allowed to deduct interest payments made to depositors and other lenders even when their funds are used to finance the purchase of tax-exempt securities. One result is that banks can often escape taxes entirely by offsetting tax-free income with deductible costs. This special exception was restricted to 85 percent of the previously allowed deduction in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and to 80 percent in the Deficit Reduction Act of 1984 (DEFRA). Even with this restriction, banks have a unique tax benefit--a tax deduction equal to 80 percent of the interest cost of financing tax-exempt securities. Elimination of the interest deduction for bank holdings of tax-exempt securities would increase federal tax revenues by $1.3 billion during the 1987-1991 period. One consequence of further limiting this deduction is that tax-exempt securities would become less attractive to commercial banks. This would narrow the market for such securities and therefore could raise borrowing costs to states and localities. In addition, to the extent it raised tax-exempt interest rates, it would increase the net gain to upper-income individuals from the availability of tax-exempt securities.

Repeal the Deduction for Excess Bad-Debt Reserves. Most businesses are allowed to deduct reserves for bad debts only to a "reasonable" extent determined by their actual experience. In an exception to this general rule, banks and thrift institutions are allowed a tax deduction for bad-debt reserves in excess of the amount they actually experience. These deductions are permanent; there is no provision to recapture them if repayment experience proves more favorable. Under current law, banks will be allowed a deduction for bad-debt reserves only until the end of 1987. The deduction is currently limited to 0.6 percent of total loans. For thrift institutions--savings and loan associations and mutual savings banks--the deduction may be as high as 40 percent of their taxable income if they make a specific proportion of their loans (82 percent for savings and loans, 72 percent for mutuals) for real estate, and if they meet other conditions. These deductions were limited to 85 percent of the amount of the bad-debt reserve in excess of actual experience by TEFRA, and to 80 percent by DEFRA.

If all financial institutions were prohibited from taking excess deductions after January 1, 1987, revenue gains would amount to $2.8 billion from 1987 through 1991. Without the excess bad-debt reserves deduction, thrift institutions might be less willing to invest in relatively risky mortgages. At present, however, the amount of excess reserve allowed is not related to the riskiness of an institution's loans.

Treat Credit Unions Like Other Thrift Institutions. Before 1951, savings and loan institutions, mutual savings banks, and credit unions were not subject to federal income taxes, because they were regarded as operating for the sole benefit of their members. Since 1951, only credit unions have remained tax-exempt. Financial deregulation, however, has blurred the distinction between credit unions and other financial institutions, thereby lessening the rationale for special treatment.

Repeal or Scale Back Special Deductions for Life Insurance Companies. The taxation of life insurance companies has undergone a major restructuring that started in TEFRA and was completed in DEFRA. Part of this restructuring was a compromise about the level of taxes that the life insurance industry should be expected to pay. This compromise resulted in the provisions of DEFRA that allowed all life insurance companies to deduct 20 percent of their otherwise taxable income from life insurance products, and created a special small-company deduction for small life insurance companies (generally those with assets of less than $500 million). The small-company deduction is 60 percent of taxable income up to the first $3 million, and a lesser percentage of income over $3 million, phasing down to zero at $15 million of income. (Use of the small-company deduction reduces the base for the regular 20 percent deduction.) Repealing these special provisions would increase federal revenue from the life insurance industry without requiring another major change in the tax structure of the industry. An additional argument for repealing the small-company deduction is that stability and financial security are such basic requirements of the life insurance business that it may not be in the public interest to encourage small companies.

Repeal Preferences for Property and Casualty Insurance Companies. Under current law, property and casualty (P&C) companies are allowed to deduct additions to reserves from current income for future claims without discounting for growth in the value of those reserves between the time the deduction is taken and the time the claims are paid, and without any future adjustment to include in taxable income reserves that turn out to be excessive. In addition, mutual P&C companies are allowed to take specified deductions for a Protection Against Loss (PAL) account, which does not actually have to be funded. The PAL account provides a tax deferral, partly indefinite, and partly for no more than five years. P&C insurance companies' dividends and similar distributions paid to policyholders are treated as deductible price rebates rather than taxable income, even though dividends to policyholders of mutual companies are partly distributions of earnings to the companies' owners.

Federal revenues from the P&C insurance industry could be increased, and the tax code simplified, if the tax treatment of P&C insurance companies was made more equal to the treatment of life insurance companies and other companies that offer similar products, or that self-insure. The revenue estimate provided above includes the effects of changes, beginning on January 1, 1987, that would base deductible reserve accounts on estimates of the timing of future claim payments and the companies' after-tax return on investment assets, with adjustments to income once the claims were paid to account for differences between payments and associated liabilities. It also includes the revenue gain from repealing the PAL account, and applying to the policyholders' dividends of mutual P&C insurance companies the limitations that currently apply to those of mututal life insurance companies.

All of these changes were included in the President's tax reform proposal. H.R. 3838, in contrast, includes some but not all of these proposals. It would repeal the interest deduction for bank holdings of most tax-exempt securities and the bad debt deduction for commercial banks with more than $500 million of assets. For thrift institutions, both the bad-debt reduction and the percentage of qualified assets needed to make it available would be reduced. Credit unions, however, would remain tax-exempt. The special life insurance company deduction would be repealed, and the small life insurance deduction would be reduced. Loss reserve deductions of P&C companies would be limited if they invested in tax-exempt securities, and the ability to use loss reserve deductions to reduce taxes on non-P&C income would be restricted.

REV-15 RESTRICT USE OF THE CASH METHOD OF ACCOUNTING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.4	1.0	1.1	1.1	1.2	4.8

With the cash method of accounting, a receipt is included in income when it is actually received, and expenses are deducted when they are actually paid, except for depreciation deductions. The cash method is not permissible for most accounting purposes because it does not reflect changes in accounts receivable and payable or in the size of inventories, which are integral parts of a complete accounting of income in any given period. Under the generally used accrual method of accounting, a receipt is included in income when all the events that determine the right to receive it have occurred, and an expense is deducted when all the events that determine the liability and its amount have occurred.

Under present law, most service industries and farms may use the cash method for tax purposes. The use of the cash method of accounting by some taxpayers, while others employ the more common accrual basis, can lead to a mismatching of income and deductions when the cash-method taxpayer provides a service (or farm product) to an accrual-method taxpayer. The mismatching occurs because the accrual-method taxpayer deducts the liability when it has been established, while the cash-method taxpayer is able to defer reporting the income from the same transaction until the cash payment has been received. The effect of this is to reduce federal revenues.

The cash method of accounting for tax purposes could be allowed only for businesses that averaged less than $5 million annual gross receipts over the three most recent years, and that do not regularly use any other accounting method. If this restriction took effect on January 1, 1987, but taxpayers were allowed to spread the adjustment proportionately over the next six years, it would increase federal revenues by about $5 billion over the 1987-1991 period.

Because cash-method accounting for tax purposes is relatively simple, many argue that it is justified for small businesses, which may find the accrual method complicated. Under current law, however, cash-method accounting for tax purposes is also available to banks and other businesses that already use the accrual method for financial accounting purposes, and to large service organizations that would not be unduly burdened by an accrual accounting requirement, such as accounting, law, and advertising firms.

The President's tax reform proposal would restrict use of the cash method of accounting, as described above. In contrast, H.R. 3838 would allow individuals, professional service corporations, partnerships of individuals or professional corporations, and Subchapter S corporations to continue to use the cash method for tax purposes, but would require other businesses with gross receipts over $5 million to use the accrual method. This proposal would increase federal revenues by $3.5 billion between 1987 and 1991.

REV-16 REPEAL THE DIVIDEND EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.2	0.6	0.6	0.7	0.7	2.8

Under current law, taxpayers may exclude from their adjusted gross income (AGI) up to $100 of qualified dividends from corporate share ownership ($200 for joint returns). Repeal of the exclusion effective January 1, 1987, would raise almost $3 billion in the 1987-1991 period.

The exclusion encourages taxpayers to invest in stocks until they have $100 or $200 of dividends, but provides no incentive to invest further. Repeal would have little disincentive effect because 99 percent of dividends go to people receiving more than these limits. Furthermore, encouraging widespread holdings of small amounts of stock is not necessarily desirable because stocks are a risky investment for small savers. An argument against eliminating the exclusion is that it provides some offset against double taxation of corporate dividends.

Both the President's tax reform proposal and H.R. 3838 would repeal the dividend exclusion, but would also allow corporations a 10 percent deduction for dividends paid, to reduce the double taxation of corporate income. Under H.R. 3838, the corporate dividend deductions would be phased in over 10 years, while the President proposed that it take effect on January 1, 1986.

REV-17 REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	2.1	1.4	0.7	0.5	0.0	4.7

Employee Stock Ownership Plans (ESOPs) are employee benefit plans to which the employer contributes the firm's stock, or cash to purchase its stock. The stock is held in a tax-exempt trust and neither the stock nor its dividends are taxable to the employee until distributed. An employer whose ESOP meets certain requirements can claim a credit for the full contribution, up to 0.5 percent of covered wages. The ESOP tax credit was first enacted in 1975 for a two-year trial; it has since been extended and modified several times and is now due to expire in 1988. Both the President's tax reform proposal and H.R. 3838 would repeal the credit. Repealing it as of October 1986 and making ESOP contributions deductible like most other compensation would increase revenues by almost $5 billion over the 1987-1991 period.

The purpose of the tax credit is to encourage corporations to set up and contribute to ESOPs. ESOPs with large stock holdings could broaden the ownership of corporate wealth, supplement retirement income, and strengthen political support for private enterprise. In addition, because ESOPs give employees an ownership interest in their firms, it is argued that ESOPs may improve employee motivation and raise productivity.

One objection to the tax credit is on grounds of equity. Through the tax credit, the government in effect buys stock and gives it to trusts for particular individuals. The stock gifts are unavailable to others, such as the self-employed and employees of unincorporated or nonprofit businesses. Another objection is that the credit could encourage employees to place too large a share of their wealth in the employer's stock, thereby exposing them to greater risk both as employees and as investors if the company performed poorly. In contrast, other benefits, such as pensions, which invest in a diversified portfolio, provide less risky means of accumulating savings for retirement. Finally, if employee stock ownership improves productivity, employers are likely to encourage it without a tax incentive.

REV-18 REPEAL 401(k) PLANS OR LOWER THE MAXIMUM CONTRIBUTION

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Repeal 401(k) Plans	1.9	4.2	4.9	5.9	7.0	23.8
Limit Contributions to $7,000 per Year	0.7	1.4	1.4	1.6	1.9	7.0

Section 401(k) of the Internal Revenue Code permits employers to operate profit sharing plans to which employees may contribute through salary reduction or from bonuses. These so-called "elective" amounts receive the same tax advantages as employer pension contributions and IRA contributions. Employers often supplement elective amounts with matching and other contributions. In these plans--generally called cash or deferred arrangements (CODAs)--all contributions for an employee cannot exceed the lesser of 25 percent of salary or $30,000, and all contributions to the plan cannot exceed 15 percent of total payroll. Withdrawals are precluded before age 59½ or retirement, except for disability, death, separation from service, or hardship. Contribution rates of the higher paid one-third of workers cannot exceed those of other workers by more than specified amounts.

CODAs are new and rapidly growing. They were first authorized in 1978; regulations governing them were published in late 1981. About 1.8 million persons contributed in 1983; about 5 million contribute now, and 12 million are projected to contribute by 1990. Repeal of CODAs would raise about $24 billion from 1987 through 1991.

One argument for repeal is that CODAs allow tax deductions for some saving that would take place anyway. For example, many CODAs appear to be a redesign of previously existing employer thrift plans. Second, because CODAs are new, most people do not have them. As a result, repealing CODAs would be less disruptive to retirement plans than substantial changes elsewhere in the pension system. Finally, if the Congress desired to expand tax-favored saving for retirement, greater equality of opportunity could be achieved by raising the IRA limit instead of allowing

CODAs. CODAs are available only to those whose employers offer the plan, while IRAs, in contrast, are available to all persons with earnings.

Proponents of CODAs argue that they are more effective than IRAs in encouraging retirement savings by middle- and lower-income employees because special rules make the contributions of the highest-paid conditional on the amounts contributed by the rank and file. As a result, some argue that employers are encouraged to subsidize contributions by the rank and file in the form of matching and other contributions.

Some advantages of CODAs could be retained with a smaller revenue cost by imposing separate limits on CODA contributions and on combined contributions to a CODA and an IRA. H.R. 3838 would impose a $7,000 CODA limit, with a dollar-for-dollar reduction in the $2,000 IRA limit for elective contributions to a CODA. Under this offset, a person contributing $1,500 to a CODA, for example, could contribute no more than $500 to an IRA. If made effective on January 1, 1987, this proposal would raise $0.7 billion in 1987 and $7 billion between 1987 and 1991.